



Unlocking the profit potential of new Russian technology

The key? Closing the management gap

by Harry Kelly

The big stories coming out of the Russian business world recently have a level of intrigue worthy of *War and Peace* or *Crime and Punishment*. Naturally, the colorful characters in these current dramas are connected to the Kremlin and the politics of natural resources. Western investors and economists who attempt to digest the latest developments in the Yukos affair, the friction between Russia and Ukraine over natural gas deliveries, and the geopolitics of pipeline deals are often left scratching their heads.

So why, notwithstanding these equivocal headlines, is Russia attracting higher foreign investment commitments from both public multinationals and private equity firms? Part of the reason is that the Russian economy has stabilized noticeably in the past few years and has become more investment-friendly. High oil prices have helped Russia substantially pay down its external debt, the tax rate is an attractive 15%, and GDP growth has averaged 6% per year over the past five years. What is attracting investors to Russia is not, however, economic indicators alone. The numbers matter, but just as important is Russia's "secret weapon" – its enormous, untapped pool of intellectual capital.

Russia has a long history of significant scientific and technological accomplishments. The Soviet Union, after all, was one of the world's two nuclear superpowers and was America's only competitor in the space race. The pride that the Russian people take in their country's technical capabilities has survived the passing of the Soviet Union, and it is estimated that today more than one million scientists and researchers work in Russian R&D centers. Intel, Hewlett-Packard and Motorola are just a few of the growing number of multinational companies that have established significant R&D operations in Russia to leverage this mass of technical expertise.

One reason these companies have invested in Russia is that the country's commitment to high-quality math and science education remains strong. Russian universities graduate more engineers and computer scientists per capita than almost any other country in the world, and in recent years teams from Russian schools have roundly defeated their American and Asian opponents in international computer programming competitions. Jim Sims, CEO of GEN3 Partners, a product innovation consulting firm, observes that Russia's educational system "lends itself to solving seemingly intractable manufacturing and technology problems. The reason: Russian technical education is largely cross-disciplinary. The ability to look for solutions to manufacturing problems from other industries and disciplines is critical to solving them. Lacking state of the art equipment and machinery, Russian manufacturers and product developers have had to rely on 'creativity' – finding and adapting scientific and other proven approaches from other industries."*

The combination of innovation, technical expertise, and improving macroeconomic indicators naturally might attract the attention of venture capital firms interested in

early-stage technology plays. If this is so, why have venture capitalist firms done so few early-stage deals? The reason is that successful venture deals require not only great ideas but great people, and the missing element is experienced managers who understand how to work with Russian technology teams as well as foreign investors, partners and customers.

The origins of the management gap

During the Soviet era, management of an enterprise meant little more than taking direction from central planners organized into a top-heavy bureaucracy. Because there was only one true consumer (the state) and one investor (again, the state), enterprise managers had little reason to worry about developing sales channels or maximizing IRR for their investors. Scientists and engineers had even less reason to worry about such matters, and were able devote their days to research and development.

The era of central planning has passed, and the new Russia is quickly integrating itself into the global marketplace. The younger generation of Russians is keenly interested in studying management, markets and entrepreneurship. However, the concept of venture capital is still very new in Russia, and even the most knowledgeable young Russian managers have had very little exposure to the goals and methods of private equity investment. And unlike in the United States, where technologists are familiar with venture capitalists even if they aren't making pitches themselves, in Russia most technologists have no familiarity with venture investing at all.

As venture capitalists know (and some technologists have learned the hard way), an aptitude for science and research does not necessarily translate into an aptitude for developing companies. Whether in the United States or Russia, the success of an emerging technology company depends largely on closing the management gap between technologists and their investors. The Economist Intelligence Unit put it thus: "Ideally, VC investors [in Russia] want to find local technology companies with savvy management teams whose firms would ideally be floated on a western exchange. Russian scientists certainly have the technical expertise; they only need western-style management to help deliver big profits."[†]

Interim management

Of course, if investors identify a promising technology that isn't supported by a savvy management team, they either have to re-direct their own personnel to close the management gap (taking their managers away from the work of evaluating other prospects and reporting to their limited partners) or identify another solution.

One way to close the management gap without re-directing the focus of investors or technologists is to use a team of interim managers to develop the start-up company and manage the development of its technology. A good interim management team can help a start-up company's investors and founders by internalizing their vision for the company and helping them create and meet development milestones. Good interim management should be able to develop strategic plans, oversee the operations of a company, develop a sales and marketing plan that is attuned to the needs and wishes of the global high-technology marketplace, manage the use of professional services firms, and identify sources of additional capital. In addition, an experienced team will be able to coach the R&D managers how to follow best

practices for corporate governance and ensure that the company preserves its trade secrets to extract the highest possible value from its intellectual capital.

An interim management team is particularly suited to develop a company with a "head-and-body" structure. This term describes a corporate structure in which senior management (and financing) is located in one country and the R&D managers are located in another country (typically a country with less experience interacting with venture capitalists). A head-and-body structure is highly valuable to an R&D "body", and therefore the company, because it gives the R&D body substantially better access to capital markets, customers and strategic partners, and eventually to permanent management. As an alternative to training technologists to manage general operations, a company can use an interim management team – a team that has an infrastructure in the same markets as where the company's customers and strategic partners will be located – to step in quickly to operate as the company's "head".

One example of successful interim management is the relationship that Starboard Ventures LLC has with Sparsix Corporation, a US-Russian enterprise. Sparsix was formed to commercialize a new technology developed by a team of esteemed Russian mathematicians and computer scientists, and Starboard Ventures has been its interim management team since Sparsix's inception. The Sparsix R&D team is located in Russia, but the Starboard Ventures team is based in the United States. As the interim management team, Starboard Ventures has supported Sparsix by identifying areas for organizational development, identifying and addressing legal issues (including corporate structuring and intellectual property rights in the United States and Russia), performing market research and initiating relationships with key companies and potential partners, identifying plausible business models and creating financial models, and mapping product development to market requirements.

An investor's ability to develop a new Russian start-up company and find an attractive exit will depend greatly on how early in the company's life the investor closes the management gap. In a country with so much technical expertise and so little venture capital industry experience, interim management teams that speak the language of both technology and venture capital are a cost-effective way to close the management gap and open up the road toward exceptional returns.

Harry Kelly is a principal in Starboard Ventures LLC, where he uses his experience with start-up companies and law firms in the US and the former Soviet Union to provide business advice to companies operating in Russia. Starboard Ventures is a management consulting firm that specializes in commercializing technologies from Central and Eastern Europe and Eurasia. For more information about Starboard Ventures, visit the company's website at www.starboardventuresllc.com.

* Jim Sims and Sam Kogan, "How American Manufacturers Can Tap Russian Innovation", *Industry Week*, October 5, 2005.

† The Economist Intelligence Unit, "Russia Technology: Techies to the Rescue", June 17, 2005.